> Some allocation to foreign income, however, is appropriate on tax policy grounds when domestic R&D is exploited in a foreign market and generates foreign, as well as domestic income. If an allocation is not made, foreign source taxable income will be too high and the higher limitation may allow the credit for foreign tax to reduce U.S. taxes on domestic source income. Thus, requiring no allocation of domestic R&D expense to foreign source income attributable to the expense can be viewed as an R&D incentive.[6]

In the Economic Recovery Tax Act (ERTA) of 1981, the Congress suspended the allocation method in S. 1.861-8 for two years and allowed the allocation of all domestic research and development expenditures to U.S. income. This temporary provision reduced tax revenues and the JCT/CBO list includes this suspension of regulation S. 1.861-8 as a tax expenditure, whereas the Administration list does not. The Treasury considers the allocation of all research expenditures to domestic income as its basic tax rule for this category.

Exclusion of Payments in Aid of Construction of Water, Sewage, Gas and Electric Utilities

Regulated utilities are generally allowed to exclude from gross income amounts contributed to aid in the construction of certain facilities. Qualifying contributions are generally made by builder-developers or local governments to assist utilities in the construction of their capital plants.[7] These payments, and the resulting facilities, may not be included in the utility's rate base, nor are they eligible for depreciation or the investment tax credit. The JCT/CBO tax expenditure list includes this provision because the contributions are considered as income under the reference tax rules. This treatment taxes contributions as income when received, but allows utilities to take the investment tax credit and depreciation over the life of any assets subsequently purchased.

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6 U.S. Department of the Treasury, The Impact of the Section 861-8 Regulation on U.S. Research and Development (June 1983), p. 32.

7 Customer connection fees do not qualify because they are considered noncapital contributions.

The Administration does not recognize this provision as a tax expenditure, based on the general tax code rule under which contributions to capital are nontaxable. In general, the Treasury considers the nontaxability of all capital contributions as one of its reference tax rules. Because this rule is consistent with the current handling of payments in aid of construction for utilities, no tax expenditure arises under the Administration's interpretation of the reference tax structure.

Deductibility of Patronage Dividends and Certain Other Items of Cooperatives

Currently, firms organized on a cooperative basis may deduct their dividends from gross income.[8] Unlike regular corporations, cooperatives can avoid the corporate income tax by distributing dividends or by issuing certificates representing the "rights" to their earnings. Thus, the tax law basically exempts (in whole or in part) the income of certain business organizations from the corporate income tax. Income is taxed, however, to the members under the individual or the corporate income tax (if the members are corporations).

The JCT/CBO list includes the dividend deduction for cooperatives as a tax expenditure, based on the rationale that the firms are similar to corporations and should be treated in an analogous manner. That is, cooperatives, like corporations, should be treated as separate economic entities and taxed as such under the basic income tax rules.

The Administration does not include the dividend exclusion of cooperatives as a tax expenditure. The Administration recognizes the different tax rules that apply to different forms of business organization as part of the reference tax structure and does not count these provisions as tax expenditures if income is subject to either the corporate or personal income tax. For example, the tax rules that apply to Subchapter S corporations, partnerships, and cooperatives are all considered part of the reference tax structure. Because cooperative dividends generally must be included in the recipient's income, they are taxable at some level. Thus, the dividend deduction satisfies the Administration's criteria as part of the basic tax structure that allows for different forms of business enterprise.

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8 A cooperative firm is a business organized for the benefit of and owned by its patrons.

Exclusion of Employer-Provided Child Care

The Congress included a provision in ERTA that allows taxpayers to exclude payments made by employers for child care from their gross incomes. Thus, firms find it attractive to compensate employees in the form of dependent care assistance rather than cash. The CBO and JCT include this provision as a tax expenditure, reasoning that employer-provided child care is a form of income and taxable as such under reference tax rules.[9] Under the reference tax rules, deductions related to earning income would be allowed. The CBO and JCT, however, do not consider child-care expenses as allowable business expenses.

The Administration does not include the exclusion for employer-provided child care as a tax expenditure. This decision is based on the rationale that child-care expenses are legitimate costs related to earning income and are deductible under the general tax rules that allow for such deductions. Thus, the Administration views the exclusion from income as the logical counterpart of a deduction for child-care expenses.[10]

Deduction for Two-Earner Married Couples

The JCT/CBO list includes the deduction for two-earner married couples as a tax expenditure, whereas the Administration list does not. The deduction, enacted as part of ERTA, allows couples to deduct 10 percent of the "qualified" income earned by the spouse with the lower income. Qualified income has a ceiling of $30,000 and includes only direct compensation from work. This provision is intended to reduce the "marriage penalty" that arises because of the interaction of progressive tax rates and the joint filing system.

Considering this provision as a tax expenditure is a borderline case. The Administration excludes the deduction for two-earner married couples because it views the provision as a part of the general system of rate schedules and filing units that are an integral part of any income tax. The

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9 Under current law, individuals cannot deduct child-care expenses, but do receive a child-care tax credit.

10 If the employee were to pay for the child care directly, the employee would be eligible for the child-care tax credit. Both the Administration and the JCT and CBO consider the credit as a tax expenditure, although the Administration only includes the excess of the credit over the "deduction value" of child-care expenses as a tax expenditure.

Administration considers it one of the general tax rules and does not view the provision as a special benefit for a narrow class of taxpayers.

The JCT and CBO include the two-earner deduction as a tax expenditure because the deduction is special in that it is limited to $3,000 (10 percent of the $30,000 ceiling) and that it only applies to labor income. Clearly, had the Congress readjusted the joint rate schedules or allowed married individuals to be taxed separately at the lower single-person rates, the change would not have been regarded as a tax expenditure. Because the deduction applies only to labor income (investment income also gives rise to a marriage penalty), it can be argued that it allows special treatment to a certain group of taxpayers.

Exclusion of Certain Cost-Sharing Payments (Agriculture)

As provided by the Revenue Act of 1978, certain payments made to landowners by the federal and state governments may be excluded from their gross income. These payments come from programs that further conservation and improve the environment, forests, and wildlife habitat. In order for the payment to be excluded, "the Secretary of the Treasury must determine that the payment does not result in a substantial increase in the income derived from the property with respect to which the payment is made."[11] The payments have a zero tax basis (that is, they do not add to the tax basis of the property) and are taxed as ordinary income rather than capital gains if the property is sold within 20 years.

The Administration does not include this provision on its tax expenditure list. The Administration does not view the payments as income because the payments are not supposed to increase the income of the property (or its market value). Alternatively, the payments could be viewed as the public sector purchasing certain environmental improvements by funneling the payments through the private sector.

The JCT/CBO list does include the cost-sharing exclusion as a tax expenditure because the payments are considered as gross income under the JCT/CBO reference tax rules. Similarly, the costs to the firm of improving the property would be deductible or recovered through depreciation, depletion, or amortization. It can be argued, however, that, if only the public at large benefited from such cost-sharing payments--that is, the private owner realized absolutely no benefit--the payments should not be counted as income under the reference tax rules.

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11 Joint Committee on Taxation, General Explanation of the Revenue Act of 1978 (March 1979), p. 315.

APPENDIX D. DIFFERENCES IN MEASURING REVENUE LOSSES AND OUTLAY EQUIVALENTS

As discussed in Chapter II, the Administration's outlay equivalent estimates for certain tax expenditures differ from their associated revenue loss estimates for two main reasons. First, outlay equivalents often must exceed their associated revenue losses because the outlay programs result in increased taxable income. In order to compensate for the increased taxes, an outlay equivalent must reflect the gross amount necessary to assure that the recipient's income after federal tax is the same as with the tax expenditure. Second, timing differences between outlay and tax programs can cause divergences, although the amounts are usually much smaller than those necessary to compensate for increased taxes. Whereas revenue loss estimates reflect the receipt collection cycle, outlay equivalents assume spending to be spread evenly over the year, as most outlays would be.

The differences (or similarities) between the Administration's outlay equivalent and revenue loss estimates for a number of tax expenditures are discussed below. The primary focus of this appendix is whether the Administration used an increase to cover additional income taxes to estimate various types of tax expenditures. In addition, different approaches to measuring the outlay equivalent of several tax expenditures are illustrated if a plausible alternative outlay program exists.

The Investment Tax Credit

Currently, taxpayers are allowed a 10 percent investment tax credit (ITC) for purchases of depreciable equipment.[1] The credit is analogous to a capital grant from the government to industry, and if it were taxed according to the Administration's basic tax rules, firms would not be allowed to depreciate the part of the property purchased with government funds. In other words, under the reference income tax, the depreciable tax basis of property purchased with the ITC would be reduced by 10 percent (or be "fully adjusted") to reflect the investment credit; the remaining 90

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1 Property in the three-year cost recovery class is allowed a 6 percent credit. Additional investment credits are allowed for certain energy supply and conservation property, as well as for rehabilitation of structures and reforestation expenditures.

percent would be subject to regular depreciation rules. Under current law, however, the tax basis of an asset is adjusted by 50 percent so that taxpayers are allowed to depreciate one-half of the "government-financed" share of the asset.

As calculated by the Administration, the outlay equivalent for the ITC is larger than its revenue loss because the former includes the tax on depreciation deductions that firms are allowed on 50 percent of the credit. For example, suppose a firm purchases a $1,000 piece of equipment that is considered five-year property for depreciation purposes. The current investment tax credit is 10 percent, which allows the firm a $100 credit. In effect, the government has purchased 10 percent of the property for the firm. Under current law, the firm is allowed to depreciate $950 in this case. This enables the firm to take depreciation deductions on a base that is $50 greater than its net cost to the firm. In the first year, the firm may deduct 15 percent of the asset's depreciable base--$142.50 in this case--$7.50 of which is attributable to the government's ownership interest. The $7.50 deduction is worth $3.45 to the corporate taxpayer in the 46 percent marginal tax bracket. Over the life of the asset, the owner will generate extra depreciation deductions worth $23.00, or 23 percent of the initial investment tax credit. Therefore, the ITC revenue loss over the asset's life is $123.

If the government chose to provide capital subsidies through the outlay side of the budget, the recipients would not be allowed to depreciate the cost of assets purchased with government funds. Thus, an outlay program equivalent to the investment tax credit would have to provide grants to cover both the credit itself, plus the additional depreciation deductions. In the example above, the $50 that the firm could depreciate (but for which the government paid) would be worth $23.00 in reduced taxes. While the comparable outlay program would not increase taxable income because of the capital grant, the additional outlay to pay for the extra depreciation deductions would be added to taxable income. The outlay equivalent for the extra depreciation would include an income tax increase of $19.59 so that the total outlay for extra depreciation would be $42.59.[2] Thus, an outlay program equivalent to the investment tax credit would be listed at $142.59, or 43 percent percent more than the credit

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2 $42.59 equals $23.00 divided by .54. Note that if the $42.59 was taxable at 46 percent, then the after-tax income would be $23.00. That is, $23.00 = $42.59 - (.46 x 42.59).

itself.[3] (The $142.59 would consist of a $100 capital grant and $42.59 in grossed-up extra depreciation.) An investor would be indifferent between receiving this amount in the form of an outlay or the current credit plus the extra depreciation. Under the Administration's basic tax rules, the $100 capital grant would not be included in a taxpayer's income and subject to tax, although the extra $42.59 would be taxable.

Expensing of Exploration and Development Costs

In general, producers of fuel and nonfuel minerals are allowed to write off immediately ("expense") development costs that would be counted as assets and therefore "capitalized" under normal income tax rules. (Expensing is the most rapid form of accelerated depreciation.) In the case of oil and gas, for example, these costs include well drilling expenses such as fuel, labor, repairs, and supplies; equipment needed to drill and prepare wells; and nonsalvageable costs (so-called "intangible" drilling costs) to construct derricks, tanks, pipelines, and other structures. Under the reference tax rules, firms would be required to add these costs to the book value of the mineral property, and they would be recovered through the use of cost depletion--that is, deductions allowed over time as a property's mineral reserves were exhausted. (Cost depletion for mineral properties is analogous to depreciation for producers' plant and equipment.) This is the accounting treatment currently required for financial reporting purposes.

The immediate tax write-off for development costs allows mineral producers to defer tax liabilities. Although this deduction reduces tax payments in the first year, payments are correspondingly higher in future years. Thus, the expensing provisions merely change the timing of the deductions over an asset's life. This is equivalent to the government providing the taxpayer with an interest-free loan equal to the amount of the tax deferred.

The revenue loss and outlay equivalent estimates should be identical (except for differences caused by timing) and equal to the annual new net "lending" the government provides for the development of mineral deposits. The Administration treats the equivalent outlay program as a direct government loan (at a zero interest rate) to production companies. Thus, the outlay estimates equal the difference between new lending commitments less "repayments" from prior years. As with any government loan program, the loan "proceeds" (or tax benefit) are not subject to taxation as

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3 The outlay program would not be a single year appropriation, but would consist of payments over time to match the timing of the ITC and the depreciation pattern.

income. Expensed development costs are treated as a loan on the outlay side because taxpayers must repay the deferred taxes at some later date. This is in contrast to other outlay programs in which the expenditures are not typically "repaid."

The subsidy element attributable to a zero interest rate is not included by the Administration as part of the outlay calculation. Because this is clearly a benefit to the taxpayer and a cost to the government, it would be included in a comprehensive comparison of alternative programs. For example, if the Congress wanted to compare the cost of providing new low-interest loans by the federal Synthetic Fuels Corporation with the tax expenditure for intangible drilling costs, the comparative interest subsidy element would have to be considered. In general, for tax expenditure programs that result in a deferral of tax, it would be useful to include the value of interest subsidies in order to measure the provisions' full cost to the government.

Accelerated Depreciation

The Administration does not provide an outlay equivalent estimate of the accelerated depreciation on buildings and equipment enacted in the Economic Recovery Tax Act of 1981 (ERTA). Although it was generally agreed that the depreciation rules in effect before ERTA--referred to as the Asset Depreciation Range (ADR)--resulted in a tax expenditure, the Accelerated Cost Recovery System (ACRS) does not meet the Administration's new definition of a tax expenditure. The JCT/CBO list of tax expenditures includes the revenue loss associated with ACRS for four different categories: depreciation on rental housing in excess of straight-line, depreciation on buildings other than rental housing in excess of straight-line, accelerated depreciation on equipment other than leased property, and accelerated depreciation and deferral associated with safe harbor leasing. The JCT and CBO include these items because they are considered special provisions under the JCT/CBO's set of reference tax rules.

If the Administration had included the outlay equivalent for ACRS in "Special Analysis G," it would be calculated in a similar manner to the expensing of mineral development costs. Depreciation in excess of the amount that corresponds with actual (or economic) depreciation gives rise to an interest-free loan from the federal government. The loan is equivalent to the excess depreciation deduction multipled by the taxpayer's marginal tax rate. The loan is repaid in future years when depreciation based on ACRS is less than the actual depreciation of an asset.

Suppose, for example, that a firm purchases a $1,000 asset which is classified as five-year property for ACRS, but which has an actual useful

life of ten years. Also assume that the true economic depreciation rate of the asset corresponds with the sum-of-years' digits (SYD) accounting formula for depreciation.[4] Table D-1 shows the calculation of the loan "advances" and "repayments" over the life of the asset. During the first five years of the asset's life, the government makes interest-free loans to the firm in amounts equal to the deferred tax payments that the firm enjoys. Once the asset has been fully depreciated for tax purposes, the firm starts to "repay" the loan amount. Note that over the life of the asset, the sum of loan advances equals the sum of loan repayments (if the marginal rate remains the same.)

The loan amount (or outlay equivalent) equals the revenue loss from this program for each year. For an economy that is continually producing new assets and depreciating old ones, the annual net loan amount equals the difference between new loans and repayments from old ones. The annual net new lending is equal to the net revenue losses, except when timing differences over the year place amounts in different fiscal years.

Although Table D-1 only illustrates the five-year property case, the results would be comparable for other classes of property which are entitled to accelerated depreciation. Note also that the effects of the investment tax credit has been ignored in the table. In this illustration (which is eligible for a 10 percent investment credit), the annual ACRS deduction would have been reduced by 10 percent if the effects of the ITC had been included. (The 50 percent of the investment credit that firms are allowed to "depreciate" would be classified as a tax expenditure within the item for the investment credit.)

Interest

Currently, the tax law allows taxpayers to deduct interest payments for purchases of goods and services even though the associated income arising from ownership of the purchases is not taxable. For example, owner-occupied housing and other consumer durables can be financed by borrowing; the imputed income they yield, however, is not counted as taxable income. Consumer interest deductions in excess of investment income, as well as mortgage interest deductions, are therefore considered tax expenditures.

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[4] The SYD accounting formula is used here to simplify the analysis. The true economic depreciation pattern of an asset may, in fact, be much different.

TABLE D-1. CALCULATION OF OUTLAY (LOAN) EQUIVALENT FOR AN ASSET IN THE FIVE-YEAR RECOVERY CLASS (By fiscal year, in dollars)

Fiscal Year	Tax Depreciation Based on ACRS	Economic Depreciation (SYD)	Excess (+) or Shortfall (-) Depreciation	Loan Amount (+) or Loan Repayment (-)[a]
1	$ 150	$ 91	+59	+27
2	220	173	+47	+22
3	210	155	+55	+25
4	210	136	+74	+34
5	210	118	+92	+42
6	0	100	-100	-46
7	0	82	-82	-38
8	0	64	-64	-29
9	0	45	-45	-21
10	0	27	-27	-12
11	0	9	-9	-4
Total	$1,000	$1,000	0	0

NOTE: The asset has an historical cost of $1,000 and no inflation is assumed. The effects of the investment tax credit have been ignored.

a. The loan amount or repayment is calculated as the product of the excess or shortfall in column three and the taxpayer's marginal tax rate, which is assumed to be the corporate rate of 46 percent.

The comparable outlay program for the mortgage interest deduction used by the Administration assumes that the government pays lenders to provide low-interest loans to borrowers. For example, suppose a homebuyer in the 30 percent marginal tax bracket obtains a 15 percent mortgage. The after-tax cost of borrowing is only 10.5 percent because the interest payments are deducted ((1-.3) x 15% = 10.5%). If the outstanding principal is $75,000, the current tax subsidy provided to the homeowner is $3,375 ((15-10.5) percent of $75,000). Under an outlay program, the government could pay the lender $3,375 to provide below market financing to homeowners (10.5 percent in this case). (This is

similar to how interest subsidies are currently provided, for example, through the student loan program.) The lender would receive the same after-tax income as under the tax subsidy approach. Just like other interest income, the $3,375 would be subject to income tax at the lender's marginal tax rate, but this amount would not be increased (grossed-up) to cover the additional taxes. In the case of interest deductions, the revenue loss and outlay equivalent approaches yield the same results, except for timing differences.

The mortgage interest deduction also could be calculated on an outlay equivalent basis as a matching grant to the taxpayer. Again, according to the Administration's procedures, this would not involve a gross-up, since the grant would not be included in the taxpayer's income. Using the same conditions as in the example above, the borrower would be provided with a grant equal to $3,375. In this case, however, the borrower would pay the market interest rate on his mortgage. When an interest rate (or any price) subsidy is provided by the government or by business, it is not counted as part of a taxpayer's taxable income by the Administration. For example, if General Motors provides price rebates or below market financing, the car buyer's taxable income is not altered. It has been argued, however, that selective price discounts should be counted as taxable income to the recipient. Under this view, any tax expenditure that effectively reduces interest rates (or prices) would be grossed-up for income taxes.

State and Local Taxes

Federal tax law currently allows taxpayers to deduct personal and real property taxes, sales taxes, and income taxes levied by state and local governments. To the extent that these taxes are not the result of activities related to the generation of business income, the deduction for taxes is considered a tax expenditure. The deduction is viewed as a subsidy for the purchase of goods and services provided by state and local governments. For example, if a school district assesses a taxpayer $1,000 in property taxes, and the taxpayer is in the 30 percent tax bracket, the after-tax cost to the taxpayer of "buying" $1,000 in educational services is only $700. The taxpayer's real estate levy is reduced by the federal government's $300 "contribution."

A direct outlay program comparable to the deduction for state and local taxes would be similar to the outlay program assumed for the deduction of interest. The government would provide a direct grant of $300 to the school district in order to pay for $1,000 in educational services. The homeowner would be directly assessed only $700 and would be left as well off in after-tax terms as under the tax deduction approach.

As a general rule, tax subsidies provided to individuals to purchase goods and services show no differences between their revenue losses and their outlay equivalents, as calculated by the Administration. The reason for this is that the tax benefit currently given directly to taxpayers in the form of a tax reduction would be transferred to sellers of the goods or services under an outlay equivalent program, in exchange for providing buyers with a price that equalled their prior after-tax cost. Alternatively, the comparable outlay program could also be designed so as to provide direct payments to individuals. In either case, the Administration's estimate of the revenue loss is equal to the comparable outlay equivalent, except for timing factors. This is true for the consumer interest and state and local tax deductions, as well as the deductions for medical expenses, charitable contributions, and the credits for political contributions. Again, it should be noted that some economists view the tax subsidies used to purchase goods or services as income and argue that an income tax gross-up is in fact required in computing the outlay equivalent in these cases.

Tax-Exempt Interest

The interest on bonds issued by state and local governments to finance general government operations or other selected projects, such as housing or industrial development, is currently exempt from federal income tax. This results in lower interest costs to state and local governments and tax-exempt income for the bondholders. Consequently, the federal government loses the tax revenues from what otherwise would be taxable income under reference tax rules.

The outlay equivalent calculation for tax-exempt interest is the same as the revenue loss calculation, except for timing factors. The corresponding outlay program would eliminate the exemption for interest and result in a higher market interest rate that would compensate lenders for the loss of their tax-preferred status. The federal government could pay state and local governments the differential between the tax-exempt and taxable interest rate in order to maintain their real cost of borrowing. Alternatively, the bondholders could be paid a matching grant by the federal government to hold state and local bonds. In this case, the state or local government's interest rate would remain the same as before. The matching grant would be directly related to each bondholder's marginal tax rate so as to maintain the distribution of the present subsidy. Under either alternative outlay program, there would be no tax gross-up under the Administration's procedures because the grant would not change any party's taxable income.

Consider, for example, a city that issues $1,000 in bonds at a 10 percent interest rate. Also assume that the investor in these bonds has a

33 percent marginal tax rate, and that the market interest rate for similar taxable bonds is 15 percent. The current revenue loss to the federal government is 33 percent of the interest that would be paid if the bonds were not tax exempt, yielding a loss of $50 (0.33 x (0.15 x $1,000) = $50). The outlay equivalent program would remove the tax exemption, leading to a rise in the bond interest rate to the market level. The investor's after-tax income would be left unchanged since the extra interest received would be $50 (.05 x $1,000) which would just offset the tax increase (.33 x 150). The city, however, would have its interest expense increased by $50 (the result of paying a 15 percent rate instead of 10 percent) and the federal government would cover this shortfall. Thus, both parties would be left in the same financial position as before.

Fringe Benefits

Currently, fringe benefits provided by employers are often not included in an employee's taxable income. These benefits include contributions for medical insurance, group term life insurance, accident and disability insurance, and educational assistance. By excluding these benefits from taxable income, the federal government is essentially providing a matching grant to the taxpayer equal to the individual's marginal tax rate times the amount excluded. For example, the taxpayer in the 30 percent bracket receives $0.30 for every dollar contributed through tax-sheltered benefit plans. Thus, if an employer pays $100 for medical insurance, the taxpayer saves $30 in taxes that would have been levied had the $100 been received instead as wages and then used to buy insurance.

An outlay program comparable to employer-provided fringe benefits would give matching grants to individuals based on the amounts employees (or their employers) contribute to eligible plans. In this case, contributions would not be exempt from tax, regardless of which party actually made the contribution. Because the government's matching grant would also be counted as taxable income, the grant (and hence the outlay equivalent) would have to be larger than the revenue loss from the current tax exemption. In the above case, the taxpayer would receive $100 for insurance that would be taxable, resulting in $70 in after-tax income. If the government gave the individual only $130, the taxpayer's after-tax income would be only $91 ($130 - ($130 x 0.3)). The government would have to provide a $43 grant in order to maintain the taxpayer's after-tax income at the same level as before ($143 - ($143 x 0.3) -$100). In this case, the outlay equivalent is 43 percent higher than the comparable $30 revenue loss. For the taxpayer in the 30 percent tax bracket, the government would pay the individual $0.43 for every dollar contributed to a qualified fringe benefit plan.

Employee benefit plans for pensions, such as group pension plans, IRAs, or Keogh accounts, are handled differently because they basically result in a deferral of tax rather than an exclusion. Although retirement contributions to eligible plans are excluded from the taxpayer's current income, they are taxable when they are withdrawn in future years. The primary advantage of these pension accounts is that they can accrue interest income at a tax-free rate of interest on the gross (pre-tax) initial investment. Another advantage of these pension plans is that the income excluded during working years will generally be taxed at a lower rate when it is withdrawn during retirement.

The outlay equivalent program for pension plans could consist of federal government matching grants equal to the interest subsidy element conferred by exclusion of pension interest earnings from taxation. These matching grants would have to be increased to reflect further additional income taxes if the interest subsidy grant were considered to be an increase in the recipient's taxable income. Furthermore, since the estimated differential in tax rates between working years and retirement would have to be included, the outlay equivalent program would tax contributions to pension plans, but would exempt withdrawals during retirement. This additional grant would also have to be grossed-up since it would also represent an increment to the recipient's income. The result of these adjustments would be to ensure that retirees would receive the same amount in tax-free retirement income under the outlay equivalent program that they now receive after tax under present pension arrangements.

Government Transfer Payments

In general, most government transfer payments to individuals, such as AFDC, Social Security, unemployment insurance and railroad retirement, are partially or completely exempt from federal income taxation. These payments give rise to tax expenditures as do other less explicit income support tax programs, such as the additional exemption for the elderly or blind. The revenue loss estimates represent the amount of tax revenue that the government forgoes as a result of these exemptions.[5]

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5 It should be noted that the Administration does not consider the exemption of public assistance benefits to be a tax expenditure because the exemption is consistent with the Administration's reference tax rules. These tax rules exempt from taxation income that is considered a "gift," such as AFDC, SSI, or fellowship awards. On the other hand, benefits related to employment, such as Social Security, railroad retirement, unemployment insurance, are considered taxable

The comparable outlay program for this kind of tax expenditure would simply be an increase in existing benefit levels to cover the increased taxable income resulting from the elimination of their tax-exempt status. For example, all Social Security income would be taxed in full and benefit levels would be adjusted to leave recipients as well off as before.[6] For example, a taxpayer in the 11 percent tax bracket with Social Security benefits of $1,000 now receives a tax benefit of $110. (This is the government's revenue loss.) Under the outlay equivalent approach, benefits would have to rise by $124 in order to maintain an after-tax income of $1,000 ($1,124 -($1,124 x 0.11) = $1,000).

Although the outlay equivalent is greater than the revenue loss, the net cost to the federal government would equal the revenue loss because of the increase in taxable income. In this example, the government's benefit payments would go up by $124 while tax receipts would rise by $14 for a net effect of $110.

This approach is used in calculating the outlay equivalent for all transfer programs in which the benefits are exempt from taxation. The outlay equivalent should equal the revenue loss after it has been increased to reflect the additional tax payments that would arise if the benefits were in fact made taxable.

Capital Gains

In general, income that is generated upon the sale of an asset held for more than one year is subject to preferential tax treatment because 60 percent of the gain is exempt from tax. The preferential taxation of capital gains gives rise to a tax expenditure because the reference tax rules require full taxation of all income from whatever source.[7]

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under the Administration's reference rules because they constitute a return from work.

6 Starting in 1984, the Social Security benefits of those households with income in excess of $32,000 ($25,000 for individuals) will be subject to income tax.

7 Under the Administration and JCT/CBO reference tax rules, capital gains are not indexed for inflation, but are subject to full taxation. This results in ordinary income taxation of purely inflationary gains. This creates a problem for all sources of capital income and expenses, such as interest or dividends.

The outlay equivalent to the capital gains exclusion assumes a taxable matching grant to investors, payable when they sell their assets. Suppose an investor in a 50 percent tax bracket sells a common stock that had been held over one year and had achieved a gain of $500. Currently, the Treasury would lose $150 in revenue because $300 (60 percent) would be excluded from taxable income, and the taxpayer's liability would be $100 (.5 x .40 x $500). If the gain were made fully taxable, the investor's after-tax income would be $250--$150 less than under current law. In this case, the federal government would have to provide an additional taxable grant of $300--or twice the revenue loss amount--in order to restore the taxpayer's original after-tax income. Because taxpayers who earn long-term capital gains are typically in high tax brackets, the outlay equivalent estimate is much higher than the comparable revenue loss amount.

The same type of approach is used to calculate outlay equivalents for capital gains related to timber sales, coal royalties, iron ore, and those related to the basis carryover that occurs when an asset owner dies. For example, when an asset owner dies, the direct outlay program corresponding to the basis carryover would be a matching grant to the decedent's estate. The grant would be equal to the loss of tax that would have been paid had the gain been realized at death, increased to reflect the assumption the grant itself would constitute taxable income.